

Conspicuous Leisure: Optimal Income Taxation when both Relative Consumption and Relative Leisure Matter**

Thomas Aronsson and Olof Johansson-Stenman⁺*

April 2009

Abstract

Previous studies on public policy under relative consumption concerns have ignored the role of leisure comparisons. This paper considers a two-type optimal nonlinear income tax model where people care both about their relative consumption *and* their relative leisure. Increased consumption positionality typically implies higher marginal income tax rates for both the high-ability and the low-ability type, whereas leisure positionality has an offsetting role. However, this offsetting role is not symmetric; concern about relative leisure implies a progressive income tax component, i.e., a component that is larger for the high-ability than for the low-ability type. Moreover, leisure positionality does not modify the policy rule for public good provision when the income tax is optimally chosen.

Keywords: Optimal taxation, redistribution, public goods, relative consumption, status, positional goods.

JEL Classification: D62, H21, H23, H41.

** The authors would like to thank Sören Blomquist, Tomas Sjögren and participants at the Nordic Workshop on Tax Policy and Public Economics held in Uppsala 2008 for helpful comments and suggestions. Aronsson would like to thank the Bank of Sweden Tercentenary Foundation, the Swedish Council for Working Life and Social Research and the National Tax Board for a research grant, and Johansson-Stenman would like to thank the Swedish Research Council for a research grant.

* Address: Department of Economics, Umeå University, SE – 901 87 Umeå, Sweden. E-mail: Thomas.Aronsson@econ.umu.se

⁺ Address: Department of Economics, School of Business, Economics and Law, University of Gothenburg, SE – 405 30 Gothenburg, Sweden. E-mail: Olof.Johansson@economics.gu.se

I. Introduction

There is a substantial body of empirical evidence suggesting that people do not only value their absolute consumption (broadly defined); they are also concerned with their consumption relative to that by others.¹ There is also a growing literature dealing with optimal policy responses to such relative consumption concerns.² As far as we know, however, no previous theoretical study has analyzed the role of relative leisure comparisons, which is somewhat surprising since the role of leisure in social comparisons was highlighted already by Veblen (1899) in his *The Theory of the Leisure Class*.³ In the present paper, therefore, we consider optimal redistributive income taxation – and briefly discuss public good provision – in an economy where private consumption *and* leisure are subject to relative social comparisons, i.e., consumer behavior is governed by positional preferences regarding both private consumption and leisure.

Why is leisure positionality interesting in the context of optimal income taxation, and why should it be examined simultaneously with consumption positionality? First, the idea that individuals may signal their status both via relative consumption and relative leisure is an old one. Second, there is empirical evidence suggesting that social

¹ This includes happiness research (e.g., Easterlin 2001; Blanchflower and Oswald 2004; Ferrer-i-Carbonell 2005; Luttmer 2005), questionnaire-based experiments (e.g., Johansson-Stenman et al. 2002; Solnick and Hemenway 2005; Carlsson et al. 2007), and, more recently, brain science (Fliessbach et al. 2007). There are also recent evolutionary models consistent with relative consumption concerns (Samuelson 2004; Rayo and Becker 2007). Stevenson and Wolfers (2008) constitute a recent exception in the happiness literature, claiming that the role of relative income is overstated.

² See, e.g., Boskin and Sheshinski (1978), Layard (1980), Oswald (1983), Ng (1987), Blomquist (1993), Corneo and Jeanne (1997, 2001), Brekke and Howarth (2002), Abel (2005), Aronsson and Johansson-Stenman (2008, 2009), and Wendner and Goulder (2008). An alternative approach is to assume conventional preferences where relative consumption instead has instrumental value; see, e.g., Cole et al. (1992, 1998). Clark et al. (2008) provide a good overview of both the empirical evidence and economic implications of relative consumption concerns.

³ Aronsson and Sjögren (in press) address the related issue of social norms in the labor market (which affect choices of number of work hours as well as participation) and their implications for optimal redistributive nonlinear income taxation.

interaction in the labor market influences the labor-leisure choice.⁴ As a consequence, it becomes important to understand how social comparisons with respect to leisure add to the corrective role of taxation compared to models where only the private consumption (not leisure) is subject to such comparisons. Note also that this argument remains valid irrespective of whether leisure – or services correlated with leisure such as vacation – is more or less positional than other aspects of private consumption.⁵ Our study extends the analysis by Aronsson and Johansson-Stenman (2008), which considers optimal nonlinear income taxation and public good provision in the simplified case where leisure is completely non-positional, while allowing individual utility to depend both on absolute and relative private consumption. Third, if positional preferences regarding leisure affect the labor market outcome, it follows that the functioning of the labor market differs in a fundamental way from the conventional models used in most previous studies on redistributive income taxation. This may, in turn, have implications for the optimal structure of redistributive taxation.

Following Aronsson and Johansson-Stenman (2008), our study is based on a two-type optimal income tax model – where the government implements a nonlinear income tax subject to a self-selection constraint – developed in its original form by Stern (1982) and Stiglitz (1982). In our framework, therefore, the use of distortionary

⁴ Aronsson et al. (1999) find that the individual choice of number of work hours depends on the average hours of work in the relevant reference group. In addition, their results show that if we were to neglect this social interaction (which is the common approach in the literature on labor supply), then we may seriously underestimate the effects of taxes on labor supply. Frijters and Leigh (2009) consider an economy where individuals value relative consumption and relative leisure, and where the “visibility” of relative leisure depends positively on the amount of time the individual has lived in the same neighborhood as well as positively on the amount of time that others have lived in the neighborhood. Therefore, if population turnover increases, the visibility (and, therefore, utility) of relative leisure decreases, and the status race will be played primarily via relative consumption. In an empirical application based on U.S. data, they find support for this hypothesis in the sense that an increase in population turnover increases the average work week of those who do not migrate. See also Pingle and Mitchell (2002), who find evidence of leisure positionality in a questionnaire-based study.

⁵ There is not much empirical evidence here. However, Alpizar et al. (2005), Solnick and Hemenway (2005), and Carlsson et al. (2007) all seem to indicate that leisure is typically less positional than many private goods.

taxation is a consequence of optimization subject to informational limitations only, and not of any other a priori restriction on the set of policy instruments (such as the necessity to use linear taxation). This framework is particularly suited for studying how redistributive *and* corrective aspects of public policy contribute to the income tax structure, as well as for capturing the policy incentives caused by interaction between the incentive constraint and the desire to internalize positional externalities. The results show (among other things) that the incentive for the government to increase the marginal income tax rate in response to the positional consumption externality is, in part, offset by the appearance of leisure positionality. However, this offsetting role is not symmetric; in particular, it is shown that concern about relative leisure implies a progressive income tax component, i.e., one that is larger for the high-ability than for the low-ability type. Our results also imply that the optimal provision rule for the public good is affected by consumption positionality, while it remains unaffected by leisure positionality.

The outline of the study is as follows. Section 2 presents the model and analyzes the outcome of private optimization, whereas the optimal tax problem is characterized in Section 3. Section 4 presents the optimal income taxation and public good provision results under relative consumption and leisure comparisons, whereas Section 5 provides some concluding remarks.

II. Consumer Preferences and the Labor Supply Problem

There are two types of individuals: the less productive low-ability type (type 1) and the more productive high-ability type (type 2). n^i denotes the number of individuals of ability-type i . An individual of ability-type i cares about his/her private consumption, x^i , the provision of a public good, g , and leisure, z^i , which is given by a time endowment, H , less number of work hours, l^i .

We also assume that each individual compares his/her own private consumption and leisure, respectively, with that of other people. In accordance with the bulk of previous comparable literature on relative consumption comparisons, yet with the modification that leisure is also a positional good here, we assume that the reference

levels are given by the average consumption and time spent on leisure, respectively. Hence, they can be written as $\bar{x} \equiv (n^1 x^1 + n^2 x^2)/(n^1 + n^2)$ and $\bar{z} \equiv (n^1 z^1 + n^2 z^2)/(n^1 + n^2)$.⁶ We also follow previous literature in assuming that the relative consumption of private goods and leisure can be described by the *difference* between an individual's own consumption or leisure and the mean consumption and leisure in the economy as a whole; i.e., people care about $\Delta_x^i = x^i - \bar{x}$ and $\Delta_z^i = z^i - \bar{z}$.⁷

The utility function of ability-type i can then be written as

$$U^i = v^i(x^i, z^i, \Delta_x^i, \Delta_z^i, g) = u^i(x^i, z^i, \bar{x}, \bar{z}, g). \quad (1)$$

The function $v^i(\cdot)$ is increasing in each argument, implying that $u^i(\cdot)$ is decreasing in \bar{x} and \bar{z} and increasing in the other arguments; both $v^i(\cdot)$ and $u^i(\cdot)$ are assumed to be twice continuously differentiable in their respective arguments and strictly concave. The individuals treat \bar{x} and \bar{z} as exogenous.

In order to measure the extent to which relative consumption and leisure concerns matter for an individual, let us extend the definition in Johansson-Stenman et al. (2002) and define the *degree of consumption and leisure positionality*, respectively,

⁶ Although this mean value comparison is the common approach in previous comparable literature, one can certainly imagine that individuals tend to compare themselves more with some people than with others (even if the available empirical evidence is scarce). Aronsson and Johansson-Stenman (2009) analyze optimal redistributive income taxation in an intertemporal model allowing both for within-generation comparisons and upward comparisons (for private consumption only; leisure is treated as a non-positional good). They find that the results from using these alternative measures of reference consumption closely resemble those that follow from a mean value comparison (even if the interpretations are modified accordingly). It is possible to modify the results here for different reference levels in a similar way.

⁷ See Akerlof (1997), Corneo and Jeanne (1997), Ljungqvist and Uhlig (2000), Bowles and Park (2005) and Carlsson et al. (2007) as well as the studies mentioned in Footnote 2. Alternative approaches include ratio comparisons (Boskin and Sheshinski 1978; Layard 1980; Wendner and Goulder 2008) and comparisons of ordinal rank (Frank 1985; Hopkins and Kornienko 2004).

for ability-type i , based on the function $v^i(\cdot)$ in equation (1). To be more specific, we define the degree of consumption positionality, α^i , and the degree of leisure positionality, β^i , as:

$$\alpha^i = \frac{v_{\Delta x}^i}{v_x^i + v_{\Delta x}^i} \quad \text{and} \quad \beta^i = \frac{v_{\Delta z}^i}{v_z^i + v_{\Delta z}^i}, \quad (2)$$

where $0 < \alpha^i, \beta^i < 1$ by our earlier assumptions, while the subindices attached to the function $v^i(\cdot)$ denote partial derivatives, so $v_x^i \equiv \partial v^i / \partial x^i$ and $v_{\Delta x}^i \equiv \partial v^i / \partial \Delta x^i$, etc. The variable α^i is interpretable as the fraction of the overall utility increase from the last dollar spent on consumption that is due to increased relative consumption. Similarly, β^i measures the fraction of the overall utility increase from the last time-unit spent on leisure that is due to increased relative leisure. The *average degree of positionality*, for each positionality measure, then becomes

$$\bar{\alpha} \equiv \frac{n^1 \alpha^1 + n^2 \alpha^2}{n^1 + n^2} \quad \text{and} \quad \bar{\beta} \equiv \frac{n^1 \beta^1 + n^2 \beta^2}{n^1 + n^2}, \quad (3)$$

where $0 < \bar{\alpha}, \bar{\beta} < 1$.

Let $T(w^i l^i)$ denote the income tax payment by ability-type i . The individual budget constraint is given by $w^i l^i - T(w^i l^i) = x^i$, implying the following first-order condition for number of work hours:

$$u_x^i w^i [1 - T'(w^i l^i)] = u_z^i, \quad (4)$$

where $u_x^i = \partial u^i / \partial x^i$, $u_z^i = \partial u^i / \partial z^i$, and $T'(w^i l^i) = \partial T(w^i l^i) / \partial (w^i l^i)$ is the marginal income tax rate.

Turning to the production side of the economy, we follow much of the previous literature on optimal income taxation in assuming that output is produced by a linear technology, which is interpreted to mean that the gross wage rates are fixed. This

assumption simplifies the calculations while it is not of major importance for the qualitative results to be derived below.

III. The Optimal Tax and Expenditure Problem

The objective of the government is assumed to be a Pareto efficient resource allocation, which it accomplishes by maximizing utility of the low-ability type while holding utility constant for the high-ability type, subject to a self-selection constraint and the budget constraint.⁸ The informational assumptions are conventional. The government is able to observe income, while ability is private information. We follow the standard approach in assuming that the government wants to redistribute from the high-ability to the low-ability type. This means that the most interesting aspect of self-selection is to prevent the high-ability type from pretending to be a low-ability type. The self-selection constraint that may bind then becomes

$$U^2 = u^2(x^2, z^2, \bar{x}, \bar{z}, g) \geq u^2(x^1, H - \phi l^1, \bar{x}, \bar{z}, g) = \hat{U}^2, \quad (5)$$

where $\phi = w^1 / w^2 < 1$ is the wage ratio. The expression on the right-hand side of the weak inequality is the utility of the mimicker. We can interpret ϕl^1 as measuring the number of work hours that the mimicker needs to supply in order to reach the same income as the low-ability type. Therefore, although the mimicker enjoys the same consumption as the low-ability type, he/she enjoys more leisure since the mimicker is more productive than the low-ability type.

By using $T(w^j l^j) = w^j l^j - x^j$ from the private budget constraints, it follows that the government's budget constraint can be written as

$$\sum_i n^i w^j l^j = \sum_i n^i x^i + g. \quad (6)$$

⁸ This assumption is standard. An alternative approach would be to assume that the government is maximizing a general Bergson-Samuelson social welfare function (again subject to the relevant self-selection and budget constraint). This approach would give the same outcome in terms of policy rules for the marginal income tax rates and the public good as those derived below.

Therefore, and by analogy to previous literature based on the self-selection approach to optimal income taxation, the marginal income tax rates can be derived by choosing the number of work hours and private consumption for each ability type in order to maximize the Lagrangean

$$\mathcal{L} = U^1 + \mu[U^2 - U_0^2] + \lambda[U^2 - \hat{U}^2] + \gamma\left[\sum_i n^i \{w^i l^i - x^i\} - g\right],$$

where U_0^2 is an arbitrarily fixed utility level for the high-ability type, while μ , λ , and γ are Lagrange multipliers associated with the minimum utility restriction, the self-selection constraint, and the budget constraint, respectively. The first-order conditions for z^1 , x^1 , z^2 , x^2 , and g , respectively, are then given by

$$u_z^1 - \lambda \phi \hat{u}_z^2 - \gamma n^1 w^1 + \frac{n^1}{n^1 + n^2} \frac{\partial \mathcal{L}}{\partial \bar{z}} = 0, \quad (7)$$

$$u_x^1 - \lambda \hat{u}_x^2 - \gamma n^1 + \frac{n^1}{n^1 + n^2} \frac{\partial \mathcal{L}}{\partial \bar{x}} = 0, \quad (8)$$

$$(\mu + \lambda) u_z^2 - \gamma n^2 w^2 + \frac{n^2}{n^1 + n^2} \frac{\partial \mathcal{L}}{\partial \bar{z}} = 0, \quad (9)$$

$$(\mu + \lambda) u_x^2 - \gamma n^2 + \frac{n^2}{n^1 + n^2} \frac{\partial \mathcal{L}}{\partial \bar{x}} = 0, \quad (10)$$

$$u_g^1 + \mu u_g^2 + \lambda [u_g^2 - \hat{u}_g^2] - \gamma = 0, \quad (11)$$

in which $\hat{u}^2 = u^2(x^1, H - \phi l^1, \bar{x}, \bar{z}, g)$ is used to denote the utility of the mimicker measured by using the second utility formulation in equation (1). As before, a subindex attached to the utility function denotes partial derivative.

IV. Results

Let $MRS_{z,x}^i = u_z^i / u_x^i$ and $\hat{MRS}_{z,x}^2 = \hat{u}_z^2 / \hat{u}_x^2$ denote the marginal rate of substitution between leisure and private consumption for ability-type i and the mimicker, respectively, and let $N = n^1 + n^2$ denote population size. By combining equations (7) and (8) and equations (9) and (10), respectively, and by using the private first-order condition for the number of work hours given by equation (4), we obtain the

following general additive expressions for the optimal marginal income tax rate (for $i=1, 2$):

$$T'(w^i l^i) = \tau^i + \frac{1}{N\gamma w^i} \left(\frac{\partial \mathcal{E}}{\partial \bar{z}} - MRS_{z,x}^i \frac{\partial \mathcal{E}}{\partial \bar{x}} \right). \quad (12)$$

Here, τ^i represents the marginal income tax rate implemented for ability-type i in the standard two-type model without positional preferences, i.e.,

$$\tau^1 = \frac{\lambda^*}{n^1 w^1} (MRS_{z,x}^1 - \hat{MRS}_{z,x}^2 \phi) \text{ and } \tau^2 = 0$$

where $\lambda^* = \lambda \hat{u}_x^2 / \gamma > 0$. The formulas for τ^1 and τ^2 coincide with the marginal income tax rates derived by Stiglitz (1982) for an economy with fixed before-tax wage rates. The intuition is that the government may relax the self-selection constraint by imposing a marginal income tax rate on the low-ability type, whereas no such option exists with respect to the marginal income tax rate of the high-ability type.

Equation (12) thus shows that the optimal marginal income tax rate for each ability-type can be expressed as a simple additive modification of the marginal income tax rate that would apply in the absence of positional concerns. The modifying terms – given by the second part of the expression – reflect how ability-type i contributes to welfare via the average consumption and leisure, respectively. Note also that when deriving equation (12), we have only assumed that individual utility depends (negatively) on \bar{x} and \bar{z} , according to the second utility formulation in equation (1). To go further, we make use of the first utility formulation in equation (1), i.e., the function $v^i(\cdot)$, which specifies *how* each individual's utility depends on social comparisons.

By using equations (7)-(10), the welfare effect of an increase in \bar{x} and \bar{z} can be written as

$$\frac{\partial \mathcal{E}}{\partial \bar{x}} = u_{\bar{x}}^1 + (\mu + \lambda) u_{\bar{x}}^2 - \lambda \hat{u}_{\bar{x}}^2 = -\gamma N \frac{\bar{\alpha}}{1 - \bar{\alpha}} + \lambda \hat{u}_x^2 \frac{\hat{\alpha}^2 - \alpha^1}{1 - \bar{\alpha}}, \quad (13a)$$

$$\frac{\partial \mathcal{F}}{\partial \bar{z}} = u_{\bar{z}}^1 + (\mu + \lambda) u_{\bar{z}}^2 - \lambda \hat{u}_{\bar{z}}^2 = -\gamma N \frac{\bar{\beta} \bar{w} (1 + \zeta)}{1 - \bar{\beta}} + \lambda \hat{u}_{\bar{z}}^2 \frac{\hat{\beta}^2 - \phi \beta^1}{1 - \bar{\beta}}, \quad (13b)$$

respectively, where $\zeta = \text{cov}(\beta / \bar{\beta}, w / \bar{w})$ denotes the normalized covariance between the degree of leisure positionality and the before-tax wage rate. Equations (13a) and (13b) show that increases in \bar{x} and \bar{z} affect welfare via two channels: (i) via the average degree of consumption or leisure positionality (the first term) and (ii) via differences in each degree of positionality between the mimicker and low-ability type (the second term). These are also the channels via which positional preferences contribute to modify the income tax structure compared to the standard model. Note also that the second term on the right-hand side of equation (13a) and (13b), respectively, is proportional to the Lagrange multiplier of the self-selection constraint (λ), suggesting a possible tradeoff between externality correction and the desire to relax the self-selection constraint. For pedagogical reasons, we begin by analyzing how positional preferences affect the marginal income tax rates when the self-selection constraint does not bind, in which case the government may implement a first best policy, and then continue with the second best model.

First Best Taxation

In the first best case, where the self-selection constraint does not bind, we have $\lambda = 0$. In this case, marginal income taxation is used solely for corrective purposes. By using equations (12) and (13), we can then derive the following result;

Proposition 1. *In the first-best case, the marginal income tax rate for ability-type i ($i=1, 2$) can be written as*

$$T'(w^i l^i) = \bar{\alpha} - (1 + \zeta) \frac{\bar{w}}{w^i} \frac{1 - \bar{\alpha}}{1 - \bar{\beta}} \bar{\beta}. \quad (14)$$

This means that (i) $T'(w^1 l^1) < T'(w^2 l^2)$ and that (ii) the marginal income tax rate is a decreasing function of ζ for both ability types.

In equation (14), the first term on the right-hand side, $\bar{\alpha}$ (the average degree of consumption positionality) contributes to increase the marginal income tax rate. The intuition is that private consumption causes a *negative externality*, due to others' reduced relative consumption, equal to $\bar{\alpha}$ per unit of consumption. Note that if leisure were completely non-positional ($\bar{\beta} = 0$), then $T'(w^i l^i) = \bar{\alpha}$ for $i=1, 2$, as the only reason to distort the labor supply behavior in that case would be to internalize the positional consumption externality (see Aronsson and Johansson-Stenman 2008).

The second part of equation (14) is novel and reflects the corresponding *positive externality* of an increase in the number of work hours by an individual, which contributes to reduce the average time spent on leisure in the economy as a whole (meaning that relative leisure increases for other agents). This positive externality is larger if caused by the low-ability than by the high-ability type, which explains the tax progression result in Proposition 1. The reason is that the low-ability type will have to reduce leisure more than what a high-ability type must for the same consumption increase. Without a binding self-selection constraint, therefore, the optimal marginal income tax rate will be higher for the high-ability type than for the low-ability type, since it simply reflects the difference between the negative consumption externality and the positive leisure externality caused by an increase in number of work hours.

Turning to the correlation between ability and degree of leisure positionality, i.e., the effect of the variable ζ in equation (14), Proposition 1 implies that both marginal income tax rates are decreasing in ζ . In other words, the more leisure positional the low-ability type is relative to the high-ability type, ceteris paribus, the higher the implemented marginal income tax rates for both ability types. The driving force behind this result is that for a given β , a victim's marginal willingness to pay for avoiding increased leisure for others, ceteris paribus, increases with the victim's income.⁹ Therefore, the more leisure positional the low-ability type relative to the high-ability type (with $\bar{\beta}$ held constant), the smaller the positive externality of an

⁹ By combining equations (1), (3), and (4), it can be shown that a victim k 's marginal willingness to pay is proportional to k 's marginal wage rate, i.e., to $w^k(1 - T'(w^k l^k))$. The reason why the optimal tax depends on ζ , which reflects the covariance with the gross (instead of the net) wage rate, is that the marginal tax payment is part of the externality, even though it is not part of k 's marginal willingness to pay.

increase in the number of work hours due to relative leisure comparisons and, as a consequence, the larger the net marginal social cost of consumption.

Note finally that the component in equation (14) that is attributable to the positional leisure externality interacts with the average degree of consumption positionality. The intuition for this interaction effect is that if we were to increase the number of work hours by ability-type i in order to offset his/her contribution to the positional leisure externality, then a fraction $\bar{\alpha}$ of the corresponding increase in before-tax income is already taxed away by the desire to internalize the positional consumption externality, (i.e., by the first term on the right-hand side). Therefore, others people's marginal willingness to pay for increased relative leisure is only $1 - \bar{\alpha}$ times what it would have been had the positional consumption externality not been taxed away.

The following result is a direct consequence of Proposition 1:

Corollary 1.

A. For the special case where the positionality degrees are identical among types, i.e., $\alpha^1 = \alpha^2 = \bar{\alpha}$ and $\beta^1 = \beta^2 = \bar{\beta}$, we obtain

$$T'(w^i l^i) = \bar{\alpha} - \frac{\bar{w}}{w^i} \frac{1 - \bar{\alpha}}{1 - \bar{\beta}} \bar{\beta}.$$

B. For the special case where the consumption and leisure positionality degrees are equally large, and also identical among types, i.e., $\bar{\alpha} = \alpha^1 = \alpha^2 = \beta^1 = \beta^2 = \bar{\beta}$, we obtain

$$T'(w^i l^i) = \bar{\alpha} \left(1 - \frac{\bar{w}}{w^i} \right),$$

implying that the optimal marginal income tax rate is strictly positive for the high-ability type and strictly negative for the low-ability type.

Part A follows directly from equation (14), with $\zeta = 0$. Part B may at first seem surprising, since one might have conjectured that the effects of the two positional externalities would cancel out if $\bar{\alpha} = \bar{\beta}$. However, the explanation given in the context of Proposition 1 as to why the marginal income rate tax is higher for the high-

ability type than for the low-ability type still remains valid. To explain why they differ in sign here, suppose that we were to increase the number of work hours for a low-ability individual, such that his/her consumption increased by one dollar. Consider the welfare effect that this change would impose on other low-ability individuals. If the average degrees of consumption and leisure positionality were equal, then the negative effect of reduced relative consumption would exactly cancel out the positive effect of increased relative leisure. However, as we saw above, if the affected individuals have a higher before-tax wage rate, then the welfare gain of increased relative leisure would dominate the welfare loss of reduced relative consumption. Thus, the external welfare effect is either zero (for other low-ability individuals) or positive (for high-ability individuals), implying an overall positive welfare effect of more consumption, which motivates a negative marginal income tax rate. The argument for a positive marginal income tax rate implemented for the high-ability type is analogous.

Second-Best Taxation

We will now return to the more realistic second-best model and analyze how a binding self-selection constraint ($\lambda > 0$) modifies the first-best policy discussed above. To simplify the presentation of the results, let

$$\alpha_d = \frac{\lambda \hat{u}_x^2 (\hat{\alpha}^2 - \alpha^1)}{\gamma N}$$

$$\beta_d = \frac{\lambda \hat{u}_z^2 (\hat{\beta}^2 - \phi \beta^1)}{\gamma N}$$

be indicators of differences in the degree of consumption and leisure positionality, respectively, between the mimicker and the low-ability type. Note also that as the mimicker is more productive than the low-ability type, the difference in leisure positionality is adjusted by the relative wage rate.

If we use $T'_{FB}(w^i l^i)$ to summarize the first-best tax formula in equation (14) – yet evaluated in the second-best equilibrium analyzed here – we can derive the following expressions for the optimal marginal income tax rates:

Proposition 2. *The second-best marginal income tax rate is given by (for $i=1, 2$)*

$$T'(w^i l^i) = T'_{FB}(w^i l^i) + (1 - \bar{\alpha})\tau^i + \frac{1 - \bar{\alpha}}{1 - \bar{\beta}} \frac{\beta_d}{w^i} - R \frac{\alpha_d}{1 - \alpha_d}, \quad (15)$$

$$\text{where } R = 1 - \left(T'_{FB}(w^i l^i) + (1 - \bar{\alpha})\tau^i + \frac{1 - \bar{\alpha}}{1 - \bar{\beta}} \frac{\beta_d}{w^i} \right).$$

Equation (15) differs from its first-best counterpart in primarily two ways: (i) through the traditional self-selection component, τ^i , and (ii) through self-selection effects associated with positional concerns, i.e., via α_d and β_d . Let us discuss the contribution of each such additional component.

As mentioned above, the variable τ^i represents the marginal income tax rate that the government would implement in the standard two-type model without positional preferences.¹⁰ In particular, note that the effect of τ^i on the marginal income tax rate is here scaled down by the factor $(1 - \bar{\alpha})$ compared to the corresponding tax formula in the standard two-type model. The intuition behind this scale factor is that $(1 - \bar{\alpha})\tau^i$ serves to relax the self-selection constraint via channels other than relative consumption concerns, which explains why the base for this tax component is the non-positional part of marginal income. Therefore, equation (15) attaches a lower weight to the traditional self-selection component compared to the corresponding tax formula in an economy without positional concerns.

The third and fourth terms on the right-hand side together capture the incentives for the government to relax the self-selection constraint via tax-induced changes in \bar{x} and

¹⁰ As we assume fixed before-tax wage rates, we have $\tau^1 > 0$ (at least if the utility function does not differ across ability types as in Stiglitz 1982) and $\tau^2 = 0$. However, equation (15) would take the same general form in a framework with endogenous before-tax wage rates, where (under the additional assumption of constant returns to scale) $\tau^1 > 0$ and $\tau^2 < 0$. The interpretation of equation (15) presented here also covers the more general case, where the relative wage rate is responsive to tax policy.

\bar{z} . Let us start by interpreting each such term in isolation and then summarize their joint implications for optimal income taxation. Note that the third term is an extension of the expression $-\left[(1+\zeta)\bar{w}(1-\bar{\alpha})/(1-\bar{\beta})w^i\right]\bar{\beta}$ in equation (14) – which is here part of $T'_{FB}(w^i l^i)$ – and arises because the redistributive aspects of leisure positionality may either reinforce, or counteract, the incentive to correct for the positional leisure externality. The additional component here is β_d , which measures the difference in the degree of leisure positionality between the mimicker and the low-ability type. The greater the β_d , *ceteris paribus*, the higher the marginal income tax rates, since if the mimicker is more leisure positional than the low-ability type, so that $\beta_d > 0$, then a higher \bar{z} will contribute to relax the self-selection constraint. This means that a higher \bar{z} makes it relatively less attractive to become a mimicker, which in itself is socially beneficial and contributes to increase the marginal income tax rates. In this case, therefore, the corrective ($\bar{\beta}$) and redistributive (β_d) aspects of leisure positionality affect the marginal income tax rates in opposite directions. On the other hand, if $\beta_d < 0$, meaning that the low-ability type is more leisure positional (and, therefore, is hurt more by an increase in \bar{z}) than the mimicker, it follows that a higher \bar{z} works to tighten the self-selection constraint. Therefore, the corrective and redistributive aspects of leisure positionality reinforce each other. Note finally that the absolute value of the third term on the right-hand side of equation (15) is larger for the low-ability than for the high-ability type. The reason for this is similar as to why the corresponding component in the first-best tax formula is larger for the low-ability than the high-ability type, i.e., because the low-ability type has to reduce leisure more than the high-ability type for the same consumption increase.

The final term on the right-hand side of equation (15) reflects the difference between the mimicker and the low-ability with respect to consumption positionality. Note that the greater the α_d , *ceteris paribus*, the lower the marginal income tax rates, and vice versa. The intuition is that if the mimicker is more consumption positional than the low-ability type, so that $\alpha_d > 0$, then the self-selection constraint will be relaxed by an increase in the average consumption. This is socially beneficial, suggesting that the price of consumption should go down, which is obtained by reducing the marginal

income tax. On the other hand, if $\alpha_d < 0$, meaning that the low-ability type is more consumption positional than the mimicker, then an increase in the reference consumption leads to a larger utility loss for the low-ability type than it does for the mimicker. In this case, the government may relax the self-selection constraint by implementing a higher marginal income tax rate than it would otherwise have done. Note that this mechanism applies to the last dollar earned net of taxes, i.e., it does not apply to the fraction of an income increase that is already taxed away (irrespective of the underlying reason), which explains the appearance of the factor R .

In summary, we have derived the following implications of Proposition 2:

Corollary 2. *Conditional on $\bar{\alpha}$, $\bar{\beta}$, and τ^i (for $i=1,2$), there is an incentive for the government to relax the self-selection constraint by implementing (i) higher marginal income tax rates for both ability types if $\alpha_d < 0$ and $\beta_d > 0$ and (ii) lower marginal income tax rates for both ability types if $\alpha_d > 0$ and $\beta_d < 0$ than it would otherwise have done. If $\alpha_d = 0$ and $\beta_d = 0$, this policy incentive vanishes, as tax-induced changes in \bar{x} and \bar{z} will not, in this case, contribute to relax the self-selection constraint.*

The intuition behind the corollary is that if the mimicker is less consumption positional and more leisure positional than the low-ability type, a combination of lower \bar{x} and higher \bar{z} will relax the self-selection constraint. This can be accomplished via higher marginal income tax rates. An analogous argument for lower marginal income tax rates applies in case the mimicker is more consumption positional and less leisure positional than the low-ability type, in which a combination of higher \bar{x} and lower \bar{z} contributes to relax the self-selection constraint. In the special case where the mimicker and the low-ability type are equally positional in both dimensions, tax-induced changes in the reference points will, of course, neither tighten nor relax the self-selection constraint.

Public Good Provision

The policy rule for the public good can be obtained by substituting equations (8) and (10) into equation (11), and by letting $MRS_{g,x}^i = u_g^i / u_x^i$ and $\hat{MRS}_{g,x}^2 = \hat{u}_g^2 / \hat{u}_x^2$ denote the marginal rate of substitution between the public good and private consumption for ability-type i and the mimicker, respectively:

Proposition 3. *The Pareto efficient provision rule for the public good can be written as*

$$\sum_i n^i MRS_{g,x}^i = \left[1 + \lambda^* (\hat{MRS}_{g,x}^2 - MRS_{g,x}^1) \right] \frac{1 - \bar{\alpha}}{1 - \alpha_d}. \quad (16)$$

Note that this provision rule is independent of the degree of leisure positionality and is, therefore, identical to the rule derived by Aronsson and Johansson-Stenman (2008), who considered a framework where private consumption is a positional good whereas leisure is not. The intuition is straightforward: as the government has access to a general income tax – through which it can perfectly control private consumption and number of work hours – the social first-order conditions governing the number of work hours need not be used to derive the policy rule for the public good. Therefore, the policy rule governing the public good takes the same general form irrespective of whether leisure is a positional good. However, had the optimal provision rule instead been expressed with leisure or effective leisure (before-tax income) as the numeraire (cf., e.g., Mirrlees 1976), then relative leisure concerns would of course have affected the provision rule.

In other words, the modification implied by equation (16), by comparison with the standard second-best formula for public provision in a two-type model derived by Boadway and Keen (1993), is that the right-hand side is here multiplied by the term $(1 - \bar{\alpha}) / (1 - \alpha_d)$, which arises because private consumption is (in part) a positional good. The average degree of consumption positionality, $\bar{\alpha}$, works to decrease the social cost of public provision (relative to private consumption) and, therefore, increase the provision of the public good. The intuition is simply that private consumption gives rise to positional externalities, whereas public consumption does not. This effect may, in turn, either be counteracted or reinforced by the component reflecting differences in the degree of consumption positionality between the

mimicker and the low-ability type, α_d , depending on whether increased private consumption contributes to relax ($\alpha_d > 0$) or tighten ($\alpha_d < 0$) the self-selection constraint.

V. Conclusion

To the best of our knowledge, this is the first paper that explicitly highlights the role of leisure positionality when theoretically analyzing optimal public policy. In line with previous studies, we first showed that increased consumption positionality under reasonable assumptions implies higher marginal income tax rates for both the high-ability and the low-ability type. Perhaps in line with initial conjectures, we then showed that leisure positionality has an offsetting role. However, this offsetting role is not symmetric; in particular, it is shown that concern about relative leisure implies a progressive income tax component, i.e., one that is larger for the high-ability type than for the low-ability type.

Thus, both effects have important implications for redistributive policy. Consumption positionality basically reduces the social cost of redistribution, since income taxes in part internalize positional consumption externalities. Leisure positionality reduces the size of these externalities, although this effect is larger for the low-ability type, since the low-ability type has to reduce leisure more than the high-ability type for the same consumption increase, resulting in a marginal income tax component that is larger for the high-ability than for the low-ability type. We also showed how the government may exploit differences in the degree of consumption and leisure positionality, respectively, across individuals in order to relax the self-selection constraint. If the mimicking high-ability type is less consumption positional and more leisure positional than the (mimicked) low-ability type, the government may relax the self-selection constraint by implementing higher marginal income tax rates for both ability types. The opposite policy incentive applies if the mimicker is more consumption positional and less leisure positional than the low-ability type.

Finally, our results show that leisure positionality does not directly affect the formula for public good provision if derived in the same general way as in earlier comparable

literature. In fact, it is only the positional preferences for consumption that modify the policy rule for public provision relative to the second-best formula that would apply without any positional concerns. This means that there is no offsetting role of leisure positionality here. Overall, the results imply that relative concerns have important implications both for optimal income taxation and provision of public goods, and that this is the case also when leisure and private consumption are equally positional.

References

- Abel, A. B. (2005) Optimal Taxation When Consumers Have Endogenous Benchmark Levels of Consumption. *Review of Economic Studies* **72**, 1-19.
- Akerlof, G. A. (1997) Social Distance and Social Decisions. *Econometrica* **65**, 1005-1027.
- Alpizar, F., F. Carlsson and O. Johansson-Stenman (2005) How Much Do We Care About Absolute versus Relative Income and Consumption? *Journal of Economic Behavior and Organization* **56**, 405-421.
- Aronsson, T., Blomquist, S. and Sacklén, H. (1999) How to Identify Interdependent Behaviour in an Empirical Model of Labor Supply. *Journal of Applied Econometrics* **14**, 607-626, 1999.
- Aronsson, T. and O. Johansson-Stenman (2008) When the Joneses' Consumption Hurts: Optimal Public Good Provision and Nonlinear Income Taxation. *Journal of Public Economics* **92**, 986-997.
- Aronsson, T. and O. Johansson-Stenman (2009) Positional Concerns in an OLG Model: Optimal Labor and Capital Income Taxation. Revised version, mimeo.
- Aronsson, T. and Sjögren, T. (in press) Optimal Income Taxation and Social Norms in the Labor Market. *International Tax and Public Finance*.
- Blanchflower, D.G. and Oswald, A.J. (2004). 'Well-being over time in Britain and the USA'. *Journal of Public Economics*, 88, 1359-1386.
- Blomquist, S. (1993) Interdependent Behavior and the Effect of Taxes. *Journal of Public Economics* **51**, 211-218.
- Boadway, R. and M. Keen (1993) Public Goods, Self-Selection and Optimal Income Taxation. *International Economic Review* **34**, 463-78.
- Boskin, M. J. and E. Sheshinski (1978) Individual Welfare Depends upon Relative Income. *Quarterly Journal of Economics* **92**, 589-601.
- Bowles, S. and Y.-J. Park (2005) Inequality, Emulation, and Work Hours: Was Thorsten Veblen Right? *Economic Journal* **115**, F397-F413.
- Brekke, K.-A. and R. B. Howarth (2002) *Affluence, Well-Being and Environmental Quality*. Cheltenham, Edward Elgar.
- Carlsson, F., O. Johansson-Stenman and P. Martinsson (2007) Do You Enjoy Having More Than Others? Survey Evidence of Positional Goods. *Economica* **74**, 586-598.
- Clark, A. E., P. Frijters and M. A. Shields (2008) Relative Income, Happiness and Utility: An Explanation for the Easterlin Paradox and other Puzzles. *Journal of Economic Literature* **46**, 95-144.
- Cole, H. L., G. J. Mailath, and A. Postlewaite. 1992. Social Norms, Savings Behavior, and Growth. *Journal of Political Economy* **100**:1092-1125.

- Cole, H. L., G. J. Mailath, and A. Postlewaite 1998. Class Systems and the Enforcement of Social Norms. *Journal of Public Economics* **70**:5–35.
- Corneo, G. and O. Jeanne (1997) Conspicuous Consumption, Snobbism and Conformism. *Journal of Public Economics* **66**, 55-71.
- Corneo, G., and O. Jeanne (2001) Status, the Distribution of Wealth, and Growth. *Scandinavian Journal of Economics* **103**, 283-293.
- Dupor, B. and W. F. Liu (2003) Jealousy and overconsumption. *American Economic Review* **93**, 423-428.
- Easterlin, R.A. (2001) Income and Happiness: Towards a Unified Theory. *Economic Journal* **111**, 465-484.
- Ferrer-i-Carbonell, A. (2005) Income and Well-being: An Empirical Analysis of the Comparison Income Effect. *Journal of Public Economics* **89**,
- Fliessbach, K., Weber, B., Trautner, P., Dohmen, T., Sunde, U., Elger, C.E, Falk, A. (2007) Social comparison affects reward-related brain activity in the human ventral striatum, *Science*, 318, 1305-1308
- Frank, R. H. (1985) The Demand for Unobservable and Other Nonpositional Goods. *American Economic Review* **75**, 101-16.
- Frijters, P., and A. Leigh (2009) Materialism on the March: From Conspicuous Leisure to Conspicuous Consumption', *Journal of Socio Economics* 37, 1937-1945.
- Hopkins, E. and T. Kornienko (2004) Running to Keep in the Same Place: Consumer Choice as a Game of Status. *American Economic Review* **94**, 1085-1107.
- Ireland, N. J. (2001) Optimal Income Tax in the Presence of Status Effects. *Journal of Public Economics* **81**, 193-212.
- Johansson-Stenman, O., F. Carlsson and D. Daruvala (2002) Measuring Future Grandparents' Preferences for Equality and Relative Standing. *Economic Journal* **112**, 362-383.
- Layard, R. (1980) Human Satisfaction and Public Policy. *Economic Journal* **90**, 737-750.
- Ljungqvist, L. and H. Uhlig (2000) Tax Policy and Aggregate Demand Management Under Catching Up with the Joneses. *American Economic Review* **90**, 356-366.
- Luttmer, E. F. P. (2005) Neighbors as Negatives: Relative Earnings and Well-Being. *Quarterly Journal of Economics* **120**, 963-1002.
- Mirrlees, J. (1976) Optimal Tax Theory: A Synthesis. *Journal of Public Economics* **6**, 327–358.
- Ng, Y.-K. (1987) Relative Income Effects and the Appropriate Level of Public Expenditure. *Oxford Economic Papers* **39**, 293-300.
- Oswald, A. (1983) Altruism, jealousy and the theory of optimal non-linear taxation. *Journal of Public Economics* **20**, 77–87.
- Pingle, M. and M. Mitchell, "What Motivates Positional Concerns for Income?," *Journal of Economic Psychology* 23 (2002), 127-148.
- Rayo, L. and G. S. Becker (2007) Evolutionary Efficiency and Happiness. *Journal of Political Economy* **115**, 302-337.
- Samuelson, L. (2004) Information-Based Relative Consumption Effects. *Econometrica* **72**, 93-118.
- Solnick, S. and D. Hemenway (2005) Are positional concerns stronger in some domains than in others? *American Economic Review, Papers and Proceedings* **45**, 147-151.
- Stern, N. H. (1982) Optimum Taxation with Errors in Administration. *Journal of Public Economics* **17**, 181-211.

- Stevenson, B. and J. Wolfers (2008) Economic Growth and Subjective Well-Being: Reassessing the Easterlin Paradox. *Brookings Papers on Economic Activity*, Spring, 1-87.
- Stiglitz, J. E. (1982) Self-Selection and Pareto Efficient Taxation. *Journal of Public Economics* **17**, 213-240.
- Tuomala, M. (1990) *Optimal income tax and redistribution*. Clarendon Press, Oxford.
- Veblen, T. (1899) *The Theory of the Leisure Class*. New York: Viking Press.
- Wendner, R. and L. H. Goulder (2008) Status Effects, Public Goods Provision, and the Excess Burden, *Journal of Public Economics* **92**, 1968-1985.